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15 **LDCs: Mixed Outlook for IMF Arrangements** 25X1

Although the number of LDC arrangements with the International Monetary Fund (IMF) increased in 1987, repayments exceeded new drawings from the Fund in the first 10 months of last year. Nonetheless, the IMF will remain a key player in international efforts to resolve the LDC debt problem and will become somewhat more flexible in its treatment of the debt problem, in our judgment. 25X1

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21 **USSR–Eastern Europe: Inching Toward Currency Convertibility in Intra-CEMA Trade** 25X1

The CEMA premiers—at their October meeting—agreed on the first tentative steps toward currency convertibility in intra-CEMA trade, but these measures will have little immediate impact. Widespread convertibility is, at best, many years away and depends upon sweeping reforms in the domestic economies. Nonetheless, if Moscow and its supporters can push through their ambitious plans, CEMA trade and economic performance should improve substantially in the 1990s. 25X1

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Perspective

Japan: Differing Views on Prime Minister Takeshita [redacted] 25X1

By all accounts, Prime Minister Takeshita—who assumed office in November—is a skilled politician, representing the return of a more traditional, consensus-oriented Japanese prime minister whose strong suit and focus will be domestic politics rather than foreign policy. Takeshita arrives in Washington next week without an extensive track record in dealing with the United States, and his performance so far has done little to suggest his approach to bilateral relations. There is considerable disagreement among political analysts, however, over whether this approach will represent a plus or minus for US-Japanese relations. [redacted] 25X1

Those who argue that the Takeshita administration will be good for the United States tend to focus on his ability to deliver—that is, his skill and leverage in brokering the often difficult domestic agreements needed to make policy concessions that will satisfy Washington. This school of thought points to Takeshita's perceived inexperience in foreign affairs as a potential plus for the United States. Proponents of this view contend that, because any Japanese prime minister must prove his ability to manage the all-important US relationship, Takeshita will be anxious [redacted] to 25X6
keep relations with Washington on solid ground. [redacted] 25X6
[redacted] they see him as ready to make concessions to Washington, banking 25X6
on his strength at home to pacify domestic groups whose interest might be sacrificed in deals that are struck. [redacted] 25X1

Those who regard the advent of Takeshita as favorable for bilateral relations note that, because of his penchant for careful political spadework before reaching agreements, he will be able to follow through on promises in a way that Nakesone sometimes found difficult. Takeshita's political strength—grounded in his position as head of the ruling party's largest faction, his carefully maintained networks in political circles, government, and his business, and high popularity ratings—also will equip him to weather the domestic criticism that inevitably will follow any accommodations to "foreign interests." [redacted] 25X1

Others see Takeshita's traits [redacted] consensus-building 25X6
style, and impressive political connections—as having little net benefit for Washington. Indeed, in the current contentious environment, some argue that the new Prime Minister's background could present an impediment to smooth bilateral relations. These analysts suggest that, because of his focus on domestic issues, Takeshita will not strive to strengthen the US relationship but, rather, will merely attempt to stave off pressure from Washington. His political strength and high popularity ratings make it unnecessary for him to prove himself in foreign policy. In addition, to maintain his all-important ties to interest groups, such as the construction lobby, the Prime Minister is seen always keeping an eye on the needs of his backers. [redacted] 25X1

Proponents of this more downbeat view argue that Takeshita, lacking a feel for the United States, may fail to recognize when an issue is critically important to Washington. Unlike Nakasone, who made extensive use of US advisers, Takeshita has had only limited contacts with foreigners. Even when he sees the importance of an issue, Takeshita is likely to delegate the matter to the bureaucracy and the ruling party, where difficult issues, such as trade concessions, may get lost in time-consuming battles among ministries and interest groups. When decisions do emerge, they will also represent incremental change, rather than broader "solutions," addressing domestic political rather than US concerns. [redacted] 25X1

25X1 It is obviously still too early to assess how the Prime Minister will approach bilateral issues, but notwithstanding his stated desire to give US relations top priority, we believe his initial lack of action on pressing issues raises some concerns. [redacted] Takeshita has left difficult decisions, such as removing agricultural quotas declared illegal by GATT and increasing foreign access to Japan's construction market, to the bureaucracy. Although a clearer picture of Takeshita may emerge by the Toronto summit this summer, we doubt he will break new policy ground. Rather, with the US presidential and Congressional elections this fall, Tokyo may temporize in dealing with emerging issues, biding its time until the interests of a new administration and Congress become more evident. [redacted] 25X1

[redacted] 25X1

West European Trade Outlook: Implications of Japan's Export Offensive

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West European officials will press Tokyo harder in 1988 to reduce the EC's rapidly growing trade deficit with Japan. They want Tokyo to slow the diversion of exports from the United States to the EC and to open Japanese markets to their goods. Most West European officials believe that without additional constraints Japan, whose exports are now much more price competitive in the EC than in the United States, will rapidly increase sales of motor vehicles and parts and of several high-technology products. In addition, the EC's ability to stave off a Japanese export offensive is hampered by the long-run decline in Western Europe's industrial competitiveness and by self-defeating EC trade policies, which have stimulated Japanese expansion into new market sectors. EC pressure for greater access to Japanese markets could complicate the efforts of US exporters to strengthen their foothold in Japan.

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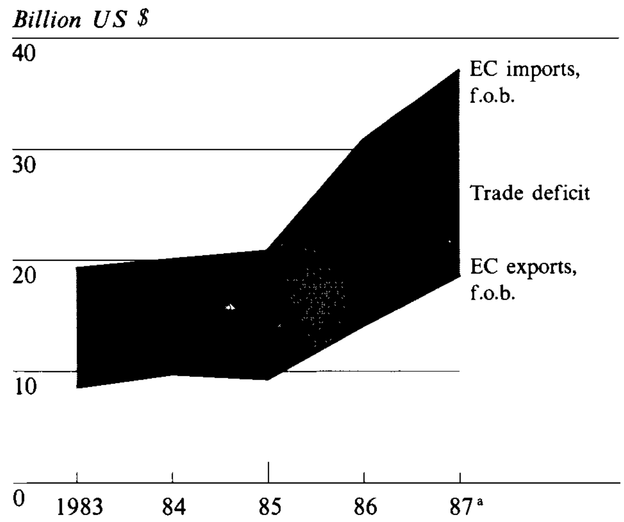
European Community: Trade With Japan, 1983-87



[a] Estimate based on partial year data.

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Export Offensive

The rapid growth of EC imports from Japan in 1986-87 has produced a trade deficit that has grown by more than 60 percent since 1985.[2] Japan's exports to the EC, expressed in dollar terms, grew more than twice as fast as exports to the United States in 1986, and almost eight times as fast in 1987. In yen terms, Japan's exports to the EC in 1986-87 grew even more impressively in relation to the actual decline of Japan's exports to the United States.

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Japan's exports to the EC have been highly concentrated in motor vehicles and parts and in several high-value, high-technology commodities. The Big Four EC countries and the Netherlands have borne the brunt of the increases in Japanese exports. EC exports to Japan have not grown fast enough to keep the deficit from increasing and have generally been concentrated in relatively lower technology areas—automobiles, organic chemicals, medical products, clothing and fabrics, and food.

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Incentives for Export Offensive

Japan's 1986-87 export offensive has been facilitated by the modest 9.2-percent appreciation of the yen against the European currency unit (ECU), compared with the 100 percent appreciation against the US

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[2] Data from Japanese Ministry of Finance and the IMF.

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EC and the United States: Imports From Japan, 1985-87

	1985	1986	1987 [a]
European Community [b] *(billion US $)*	20.9	30.9	37.2
Growth from the previous year in dollar terms *(percent)*	4.3	47.8	20.4
Growth from the previous year in yen terms *(percent)*	4.1	4.4	5.0
United States *(billion US $)*	66.6	81.8	83.9
Growth from the previous year in dollar terms *(percent)*	10.0	22.8	2.6
Growth from the previous year in yen terms *(percent)*	9.7	−13.0	−10.6

[a] Data through October annualized.
[b] EC-12 for all years.

[redacted]

dollar. This gap has left Japanese products much more price competitive in the EC market than in the United States. West European officials fear Japan will continue to exploit this gap by increasing sales to Western Europe more rapidly than to the United States. [redacted]

The failure of the EC and most of its members to remain industrially competitive in high-technology products, relative to Japan and the United States, is an additional factor behind Japan's export success. Much of EC's failure may be attributed to inadequate long-term investment, weak productivity, high real wages, and rigid labor markets. In addition, self-defeating EC trade policies often have had the perverse effect of stimulating Japanese industrial competitiveness while limiting that of the EC. EC countries have compelled Japan to place more and increasingly sophisticated products under voluntary export restraints (VERs). Each new layer of VERs has provided Japanese producers with added incentives to seek out new, higher priced, and usually higher technology areas not yet subject to restraint. As VERs began reducing television recorder sales, for example, Japanese electronics firms generated new growth in such products as data processing and telephone line equipment. [redacted]

EC Goals

The EC almost certainly will consider toughening trade policies affecting Japan during 1988. Commission officials acknowledge Japanese steps to reduce the bilateral trade imbalance but regard the pace as far too slow. EC officials worry that Japan is giving priority to the United States when making decisions affecting trade and investment, and that this will lead to the United States and Japan "dividing up the world," according to US Embassy reporting. They will place the highest priority on compelling Tokyo to give more consideration to the EC in formulating its policies. Specifically, the EC is seeking Japanese concessions on:

- EC participation in the Kansai airport construction project.
- Improvement of the Japanese import inspection system for pharmaceuticals.
- Expansion of the 24-percent share allocated to the EC in Japan's $1 billion emergency government procurement program. 25X1

In addition, the EC wants new trade consultations in selected sectors, such as dairy products and illegal imitations of West European brand name goods. It also is pressing the Japanese to comply in 1988 with a GATT ruling to reduce duties and taxes on imported wine and spirits, rather than in 1989 as the Japanese have offered. [redacted] 25X1 25X1

In other areas, the EC will continue to press for greater European access to Japan's financial markets and for Japanese assistance for EC exporters in the form of low-cost loans. The EC wants a bigger role in financing exports to Japan and full EC participation in Japan's new commercial paper market and in a transformed "modern interbank system"—like those in many European banking centers. [redacted] 25X1

Implications

The appreciation of West European currencies relative to the dollar during 1986-87 will continue to lead to lower growth in the EC and probably will encourage heightened protectionism by the Community.

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European Community: Top 15 Imports From Japan, 1985-87 [a]

Commodities	1985		1986		1987	
	Million US $	Growth From the Previous Year *(percent)*	Million US $	Growth From the Previous Year *(percent)*	Million US $	Growth From the Previous Year *(percent)*
Total	**8,641**	**6.0**	**13,619**	**57.6**	**17,301**	**27.0**
Passenger motor vehicles	2,722	−0.2	4,677	71.8	6,070	29.8
Data processing equipment	523	8.9	944	80.4	1,442	52.7
Motor vehicle parts and accessories	557	34.7	835	49.9	1,190	42.6
Television recorders	1,036	−23.0	1,027	−0.9	959	−6.6
Sound recorders	483	29.8	796	64.7	833	4.6
Trucks	401	13.0	646	61.3	763	18.0
Television cameras	303	104.7	510	68.5	741	45.2
Motorcycles	322	−9.2	537	66.7	733	36.6
Photocopying equipment	695	23.5	755	8.6	718	−4.9
Data processing parts and accessories	302	8.2	516	71.0	713	38.1
Computer peripherals	326	20.6	624	91.6	652	4.6
Digital computers	245	6.6	477	94.5	638	33.7
Telephone line equipment	133	41.6	279	110.6	629	125.1
Sound recorder parts	155	8.7	424	174.1	620	46.2
Sound recording media	438	15.9	572	30.7	601	5.1

[a] Commodities were ranked by annualized 1987 values that were based on data through October 1987. All data are in f.o.b. (free on board) terms.

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Whether initiated jointly or independently by EC members, protectionist reactions to the worsening deficit with Japan probably would contribute to reduced confidence in global financial markets in 1988 and place additional downward pressure on world economic growth.

The likelihood for increased EC discrimination against Japanese exports, contradicting GATT's multilateral philosophy, could limit negotiations in the Uruguay Round. The EC has invoked anti-Japanese protectionist measures, despite its overall trade surplus with the rest of the world, putting it in open conflict with the GATT's multilateral principle that a country's overall trade balance, not a specific bilateral trade imbalance, should guide its trade policies. In addition, many of the EC's 1987 trade policies were precedent-setting because they were targeted primarily against Japan in spite of a lack of evidence of injury to a particular European industry. These policies included: new surveillance procedures and contingency tariffs on high-technology goods targeted by US tariffs, new antidumping actions—which included imports of components as well as finished goods, and imposition of new, higher domestic content requirements targeted at all Japanese assembly plants located in Western Europe. Intensification of these protectionist trends in 1988 would increase the likelihood of 25X1

[redacted] 25X6

[redacted] 25X1

an EC-Japan trade war while complicating and slowing the Uruguay Round's negotiations. [redacted] 25X1

Because of the Community's concerns about expanding US-Japanese trade relations, the EC probably would welcome greater involvement in US-Japanese trade negotiations. [redacted] 25X6 [redacted] We believe this ad hoc approach to resolving trade disputes would provide a productive venue for moderating the EC's bilateral protectionist tendencies [redacted] 25X1

From the US perspective, the limited but measurable success of the EC's aggressive requests for greater Japanese market access have begun and will continue to reduce selected US exports. For example, in spite of current EC complaints about the inadequacy of its 24-percent share of Japan's $1 billion emergency government procurement program, the United States was originally set to get nearly all of that business. 25X6 Therefore, EC gains in the Kansai airport project and in other Japanese markets probably will come at the expense of US firms [redacted] 25X1 25X6

[redacted] 25X1

Argentina: Heading for a Showdown on Debt [redacted] 25X1

Argentina's foreign payments position has turned desperate. Buenos Aires ended 1987 with a $4 billion current account deficit and perhaps only $500 million in reserves, and we expect a similar-sized deficit this year. We believe the external payments situation, coupled with internal political pressures, is likely to compel Argentina to halt interest payments on foreign commercial debt this year unless the international financial community provides new money or an innovative way of reducing interest payments—with few strings attached. Meanwhile, international and domestic confidence in President Alfonsin's ability to manage the economy is rapidly eroding. [redacted]

Deteriorating Domestic Economy

The last bloom of President Alfonsin's 1985 economic stabilization plan has faded. Inflation reached 177 percent during 1987, according to press reports, against a government goal of 42 percent. The public-sector deficit is running at about 7 percent of GDP, compared with 4.5 percent in 1986. In addition, Argentine GDP growth—which reached 5.3 percent in 1986—is slowing to a standstill as a result of declining real wages and a dearth of investment capital. [redacted]

The economic team attempted to stabilize the situation in October by announcing a wage and price freeze, the deregulation of interest rates, a major devaluation of the austral, and a new tax package designed to halve the fiscal deficit, but the results have been disappointing. The gap between the official and parallel exchange rate quickly widened again to the 30- to 40-percent range because of lack of follow-through devaluations, and "deregulated" interest rates have failed to keep up with those on the parallel financial market. In addition, the wage and price freezes—which were lifted at the end of December—proved less effective than the previous two times Alfonsin imposed them. [redacted]

Stymied by political infighting, the emergency tax package had still not passed Congress by the end of the year, and, although the US Embassy reports that it may be passed early this month, the diversion of part of the tax revenues to provincial governments will probably dilute the measures' overall effectiveness. Buenos Aires has made even less progress on the expenditure side. Treasury Secretary Brodersohn admits that political pressures render him unable to reduce government spending, [redacted] 25X1 25X1 25X1

External Trends Portend Debt Difficulties

Argentina's policy-related domestic economic difficulties are mirrored in its external accounts. An uncompetitive exchange rate and the high cost of credit—combined with low international commodity prices and poor growing conditions—have hurt agricultural exports, while an industrial export promotion program proved less successful than the government forecast. As a result, Buenos Aires' debt service ratio burgeoned to 71 percent—one of the highest in Latin America. Meanwhile, imports increased about 15 percent last year after Buenos Aires loosened import restrictions in accordance with a World Bank trade-related structural adjustment program. [redacted] 25X1 25X1

Current account difficulties are placing increasing pressure on Argentina's fragile international reserves position. The US Embassy reports that Argentina's liquid reserves may have equaled $500 million at the end of December—enough to cover only one month of imports. Any new money comes and goes quickly. December disbursements by the IMF and the World

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Alfonsin's Economic Policy: Opportunity Lost

On 14 June 1985 President Alfonsin announced the Austral plan, which—with its price and wage freeze, introduction of a new currency, and promised end to printing-press financing of the fiscal deficit—broke the back of inflation and caused the President's popularity to skyrocket. The President, however, used the ensuing honeymoon to advance pet political initiatives, such as moving the capital to Viedma and reforming the Constitution, instead of to implement significant structural reforms of the Argentine economy.

On this score, Alfonsin's rhetoric has far outpaced his actions. In 1985 he announced plans to increase private-sector participation in the oil sector but has only recently begun to offer major concessions to international oil companies. In early 1986 he promised to privatize some of Argentina's burdensome state-owned enterprises, but has only sold one significant company—a moderate-sized airline. Alfonsin has emphasized increasing government revenues instead of decreasing expenditures, shying away in particular from the layoffs that would be necessary to limit the massive bureaucracy's draw on public finances. In addition, the President's economic team resorted to only partially successful promotion programs—rather than consistently competitive exchange rates—in an effort to boost exports. It was only a matter of time before inflation reappeared and the economy slowed down.

We believe that it may be too late for Alfonsin to regain the public's confidence in his ability to handle the economy. Many Argentines believe the current economic morass proves that the perceived sacrifices they made during the Austral plan were in vain, and they are ill disposed toward further austerity. Moreover, Alfonsin's Radical party must now compete with the newly invigorated Peronists, who will promise anything but austerity as the 1989 presidential election approaches.

[redacted] 25X1

Bank, for example, went to repay a $500 million bridge loan from the United States and several other governments. [redacted] 25X1

International banks have become ill disposed to increase lending to Argentina, and many have concluded that a debt moratorium is inevitable, [redacted] 25X1 25X1 In 25X1 addition, the IMF is becoming increasingly disillusioned with Buenos Aires' continued inability to meet performance targets on the fiscal deficit, inflation, and profit repatriation. It is unclear whether a belated passage of the tax package would be sufficient to satisfy the Fund and induce it to grant an additional performance waiver. [redacted] 25X1

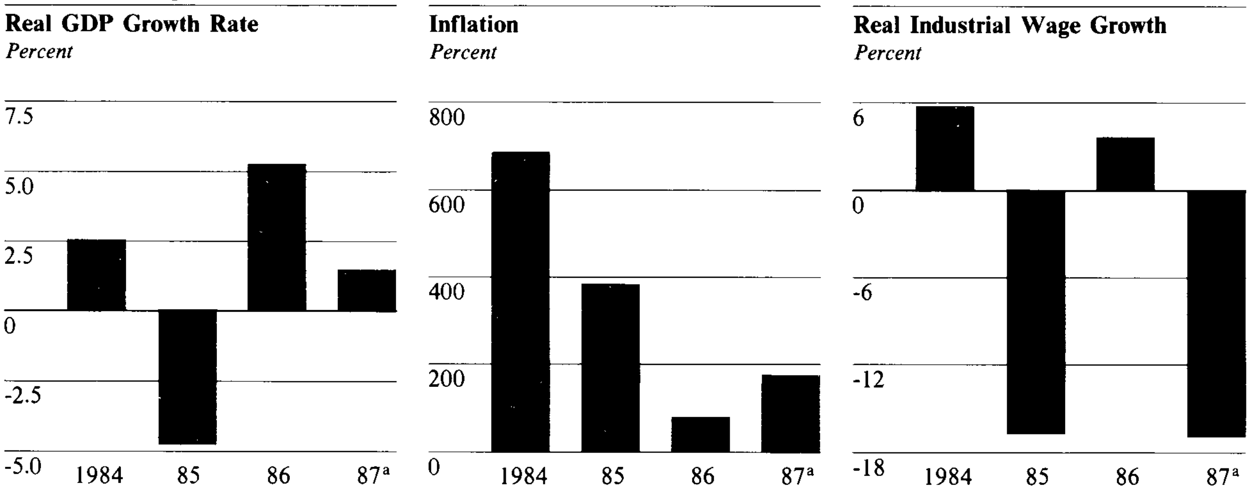
Political Pressures Build

The ruling party's loss to the Peronists during September's off-year elections has reduced Alfonsin's ability to withstand pressures for a moratorium. Organized labor and some members of Alfonsin's own Radical Party have stepped up demands for halting interest payments. The US Embassy reports that even a leading conservative Radical has publicly stated that there may be no other alternative. Moreover, Peronist leader Antonio Cafiero—who initially distanced himself from his party's traditional promoratorium stance following the September elections—has recently called for a suspension of debt payments, according to press reporting. [redacted] 25X1

Alfonsin, himself, may be warming toward the idea of a cessation of interest payments. In early November discussions with the US Ambassador in Buenos Aires, he privately threatened a debt moratorium unless the IMF granted Argentina a waiver on missed performance targets without further concessions, according to the US Embassy. Alfonsin subsequently publicly

Argentina: Selected Economic Indicators, 1984-87

Note scale change



[a] Estimated.

[redacted] 315458 1-88 25X1

endorsed limits on debt service and rejected strict IMF conditionality at the Group of Eight summit. This position was a sharp shift from the moderating influence that Argentina had exercised at previous Inter-American regional debtor conferences. [redacted]

Outlook

Severe foreign payments difficulties will continue this year. We expect increased interest rates and stepped-up capital flight to at least partially offset moderate increases in agricultural export prices and in the pace of industrial exports. Businessmen will continue to underreport exports and overinvoice imports in an effort to compensate for the overvaluation of the official exchange rate and facilitate the transfer of funds abroad. We project that Argentina will run a current account deficit of $3.9 billion this year and require an additional $2.2 billion from international creditors in order to finance it. [redacted]

Although we do not believe Buenos Aires will abandon its mildly free market oriented economic program during the coming year, it will probably become more concerned with selling its policies to the public than with heeding the views of international creditors— 25X1 thus increasing the chances for a confrontation over the debt. This would be especially true if Alfonsin decided—in light of a resurgence of inflation above the 20-percent monthly level, for example, which could occur by March—to replace Economy Minister Sourrouille with a politician such as Foreign Minister Caputo or former Interior Minister Troccoli. [redacted] 25X1

We believe the odds are better than even that Argentina will at least temporarily halt interest payments on commercial debt this year—perhaps as early as the first quarter. The first flashpoint would be a decision by the IMF not to grant Argentina another waiver at its review of October performance targets scheduled

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Argentina: Balance of Payments, 1985-88

Million US $

	1985	1986	1987 [a]	1988 [b]
Current account	−953	−2,823	−4,068	−3,872
Trade balance	4,582	2,149	792	1,663
Exports, f.o.b.	8,396	6,849	6,204	7,213
Imports, c.i.f.	3,814	4,700	5,412	5,550
Services and transfers	−5,535	−4,972	−4,860	−5,535
Interest	−5,132	−4,416	−4,400	−5,130
Capital account	2,824	2,258	2,868	3,179
Net direct investment	919	574	450	600
Net commercial bank lending	2,047	1,252	1,250	700
Other net lending	1,902	1,606	2,499	1,879
Change in arrears	−2,044	−1,174	−1,331	0
Change in reserves	1,871	−565	−1,200	1,500
Financing gap				2,193

[a] Estimated.
[b] Projected.

[redacted] 25X1

to take place this month. Buenos Aires could opt for a moratorium to counterbalance the political embarrassment of being "scolded" by the IMF. Such an IMF decision would prohibit international banks from disbursing a third $550 million tranche of their $2 billion loan during the first quarter. Therefore, even if Buenos Aires did not suspend interest payments immediately after an unfavorable IMF decision, it might have no other choice by 9 March, when a lump sum quarterly payment to banks is due. [redacted] 25X1

Other flashpoints during 1988 are on 9 June, 9 September, and 9 December, when additional interest payments to banks are due. As the year progresses, Argentina's foreign-payments situation will change from difficult to unsustainable unless it receives new money from the international financial community. [redacted] 25X1

We believe a nonconfrontational solution, however, is possible as President Alfonsin would still prefer the additional inflow of foreign funds to a debt moratorium. Since Argentina has been one of the few Latin American countries receiving new money, it has more to lose from radical action than many other debtors. Alfonsin would almost certainly be receptive to novel debt initiatives proposed by creditors. He may interpret the recently announced Mexican scheme as a signal that banks are willing to consider new proposals to reduce debtors' interest burden. A scheme analogous to plans that Alfonsin has already suggested in public—such as the capitalization of debt to fix interest payments at 3 to 4 percent—would be attractive, particularly since it would bolster the President's domestic political standing. Any initiative, however, might still need to be accompanied by sufficient new money to avert the immediate crisis and ensure a healthy reserves position. It would also need to come with few strings attached regarding economic performance. [redacted] 25X1

[redacted] 25X1

Key LDC Debtors: Continued Export Growth Tied to OECD Demand

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Key-debtor LDC export earnings rebounded strongly last year—following sharp declines the previous two years—mainly on the strength of higher oil prices and increased prices for major commodities such as copper, rubber, and sugar. We believe that for the group of key debtors that we examined, slower OECD economic growth will sharply reduce export gains this year.[1] Should the developed countries fall into recession, we forecast a sizable decline in key debtor exports. In our opinion, lower LDC export growth will tighten debtor financial pressures, increase the LDCs' need for debt relief, heighten political pressures within debtor countries, and further strain debtor-creditor relations.

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Higher LDC Exports Last Year

Higher oil prices, continued moderate economic growth in the developed countries, favorable LDC exchange rate policies, lower LDC domestic demand, and a strong rebound in commodity prices led to higher export earnings for the key LDC debtors in 1987. For the 11 countries we examined, exports jumped more than 14 percent last year, the best performance since 1980.[2] Many individual countries recorded strong export gains:

- Brazilian exports increased 15 percent last year, following declines in 1985 and 1986. Greater targeting of export markets because of lower domestic demand—as well as real exchange rate depreciation—boosted exports. Sales of soybeans, transport equipment, and manufactured goods were higher, more than offsetting lower sales of coffee and iron ore.
- Malaysian exports increased nearly 16 percent last year because of higher oil prices and sharply increased sales of textiles and electronics parts. According to US Embassy reporting, much of the growth in manufactured goods exports went to new markets in Japan and the Pacific Basin.
- Mexican export earnings soared 34 percent last year on the strength of a 46-percent jump in oil sales and strong growth of manufactured goods exports. Among major export sectors only agriculture recorded a decline, primarily because of weaker prices.
- Strong recovery in prices for coconut products boosted Philippine exports by 8 percent. Electronics and textiles exports also recorded solid growth.

Chile, Indonesia, Nigeria, Peru, and Venezuela recorded export gains ranging from 5 to 20 percent.

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On the negative side:

- Argentine export earnings fell nearly 9 percent last year, sinking to their lowest level this decade. Continued weakness in prices for agricultural products and the adverse impact of widespread flooding in agricultural production zones accounted for most of the export decline.
- Colombian export earnings fell about $250 million, or 6 percent, in 1987, following a strong $1.7 billion gain in 1986. Coffee exports fell sharply as prices plunged, but the decrease in export earnings was partially offset by higher exports of coal, oil, and nontraditional products

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[1] Argentina, Brazil, Chile, Colombia, Indonesia, Malaysia, Mexico, Nigeria, Peru, Philippines, and Venezuela.
[2] Data as of 18 December 1987.

Key Debtor LDCs: Export Earnings, 1986-88

Billion US $
(unless otherwise indicated)

	1986	1987	1988		
			I [a]	II [b]	III [c]
Total	**107.8**	**123.5**	**131.6**	**127.3**	**115.2**
Argentina	6.8	6.2	6.9	6.5	5.9
Brazil	22.4	25.8	27.8	26.7	24.6
Chile	4.2	4.7	5.1	4.9	4.5
Colombia	5.4	5.1	5.4	5.3	4.9
Indonesia	16.1	18.4	19.8	19.1	17.1
Malaysia	13.9	16.1	17.4	16.6	15.0
Mexico	16.5	22.1	23.1	22.7	20.7
Nigeria	6.6	6.9	7.0	6.9	5.8
Peru	2.5	2.7	3.0	2.8	2.6
Philippines	4.8	5.2	5.6	5.4	5.0
Venezuela	8.6	10.3	10.5	10.4	9.1
Export growth since 1987 *(percent)*	NA	NA	6.6	3.1	−6.7

[a] Case I is the moderate growth scenario.
[b] Case II is the slow growth scenario.
[c] Case III is the recession scenario.

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Forecast for 1988

We believe that key-debtor export growth this year is unlikely to match last year's performance. Even if modest OECD economic growth continues, private forecasts indicate that oil prices are likely to be more stable than in 1987, and that key commodity price gains probably will not match the increases achieved last year. To determine the impact of changes in OECD real GNP growth on key debtor export earnings, we utilized three different OECD real growth scenarios for 1988:

- Under the slow-growth scenario—which we believe to be most likely—key LDC exports would grow about $4 billion, or an average of 3 percent, but this would still mark the first time since 1979-80 that key LDC export earnings had risen two years in a row. Given the assumption that oil prices remain unchanged, nonoil exporters would realize the largest percentage increases.

- Under the moderate growth scenario, key debtor LDC export earnings would rise about 7 percent. Nonoil exporters would record the strongest export growth. Oil exporters such as Indonesia and Malaysia—whose nonoil exports are sensitive to changes in demand—also would benefit. Debtors with small nonoil export sectors, such as Nigeria and Venezuela, probably would realize smaller export gains.

- Under the recession scenario, key LDC export earnings would fall $8 billion, or nearly 7 percent, putting individual country exports at or near decade-low levels. Major oil exporters would be particularly hard hit by the combination of falling oil prices and lower prices for exports of commodities and manufactured goods.

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Key Debtor Export Earnings: Selected Commodity Price Changes and Their Impact, 1987 [a]

	Price Change Since 1986 (*percent*)	Effect on 1987 Export Earnings Due to Price Change (*million US $*)	
		Debtor	Impact
Metals			
Aluminum	24.5	Argentina	66
		Indonesia	62
		Venezuela	138
Copper	13.6	Chile	244
		Mexico	87
		Peru	59
		Philippines	12
		Zambia	50
		Zaire	50
Lead	41.4	Chile	161
		Mexico	65
		Peru	68
Nickel	11.8	Indonesia	50
		Philippines	16
Silver	25.9	Chile	37
		Mexico	261
		Peru	28
Tin	7.0	Bolivia	7
		Indonesia	62
		Malaysia	17
		Thailand	9
Zinc	3.4	Bolivia	2
		Mexico	8
		Peru	8
Agricultural Products			
Cocoa	−1.6	Ivory Coast	−16
		Indonesia	−9
		Malaysia	−6
		Nigeria	−3
Coffee	−37.0	Brazil	−899
		Colombia	−1,328
		Zaire	−132
Cotton	1.9	Egypt	2
Fishmeal	13.5	Ecuador	35
		Peru	28
		Philippines	35
Palm Oil	27.8	Malaysia	324
Sugar	8.1	Brazil	6
		Philippines	7
		Thailand	22
Wheat	−3.0	Argentina	−12

[a] Data as of 18 December 1987.

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Key LDC Export Scenarios

To determine the extent to which factors such as OECD real GNP growth, LDC nonoil export prices, exchange rates, and the price of oil exert major influences on LDC export earnings this year, we utilized three alternative scenarios:

- *A moderate growth scenario, which assumes 3 percent average real GNP growth in the OECD countries in 1988. Nonoil export prices increase 5 percent as demand for LDC commodity and manufactured exports continues to grow. Oil prices remain unchanged as increased oil demand roughly matches OPEC's continued overproduction.*

- *A slow growth scenario, which assumes 1.5 percent real GNP growth in the OECD countries in 1988. LDC nonoil export prices are assumed to increase only 2 percent as industrial country import demand slows. Oil prices remain unchanged.*

- *A recession scenario, which assumes no real GNP growth in the OECD countries in 1988. LDC nonoil export prices decrease 5 percent as OECD import demand declines. Oil prices fall $2 per barrel because of falling demand and continued overproduction.*

In each of these scenarios, it is assumed that LDC real (inflation-adjusted) exchange rates remain unchanged. To the extent that real exchange rates depreciate, LDC export earnings should increase.

[redacted]

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Implications for LDC Imports and Debt Servicing

The implications of our three alternative export scenarios for LDC imports and debt servicing vary. The solid export growth under the moderate OECD growth scenario would provide a much-needed, though modest, measure of financial relief and allow for higher imports of essential industrial inputs and spare parts. On the other hand, financial pressures likely would remain high under the slow growth scenario, with little funding available to boost imports unless debt service relief—either through unilateral action by the LDCs or negotiation with bilateral and multilateral lenders—was forthcoming. Under the recession scenario the loss of export revenue would make financial pressures much more acute, significantly increasing the need for substantial debt relief. Slow or negative export growth also could heighten political and social tensions within debtor countries, and increase strains between debtors and their creditors. [redacted] 25X1

[redacted] 25X1

LDCs: Mixed Outlook for IMF Arrangements [redacted] 25X1

Although the number of LDC arrangements with the International Monetary Fund (IMF) increased in 1987, repayments exceeded new drawings from the Fund in the first 10 months of last year. Nonetheless, the IMF will remain a key player in international efforts to resolve the LDC debt problem and will become somewhat more flexible in its treatment of the debt situation, in our judgment. The Fund, for example, will probably expand its medium-term assistance to LDCs, especially the poorer ones, as a result of the its decision to create an $8.4 billion enhanced structural adjustment facility (ESAF) to complement its existing $3 billion Structural Adjustment Facility (SAF). We believe, however, that LDC arrears and failure to meet economic performance criteria under IMF-supported programs will continue to be a problem in LDC-IMF relations. In addition, LDC leaders are likely to become more vocal this year—given mounting domestic dissatisfaction with economic austerity—in their demands for reform programs with less stringent austerity requirements and an unlinking of bank lending from IMF-supported programs. [redacted] 25X1

Arrangements Increase in 1987 . . .

The number of LDC arrangements with the IMF was 47 as of the end of October 1987—up from 40 at yearend 1986. There has been a shift, however, in the composition of the LDCs' arrangements with the Fund toward those that provide medium-term balance-of-payments assistance, such as the SAF introduced in 1986, and away from arrangements that emphasize shorter-term assistance—standby arrangements. The number of standby arrangements fell from 30 in 1986 to 25 through October 1987, while the number of SAF arrangements more than doubled from nine to 21. Chile continued to be the only member country with an arrangement under the extended fund facility—another medium-term assistance facility. [redacted] 25X1

The decline in the number of standby arrangements is a result of a failure to renew agreements, the suspension in arrangements because of failure to make timely repayments to the Fund, such as Zambia, or in the case of South Korea, success in overcoming balance-of-payments problems. Sub-Saharan African countries expanded their share of the total number of LDC standby arrangements last year—from 55 percent to 60 percent—while the number of standby arrangements for Latin American and Asian member countries declined slightly. LDCs who dropped their standby arrangements last year included Ecuador, Mali, Nepal, Panama, South Korea, Uruguay, and Zambia, while new standbys were approved for Argentina, Egypt, Jamaica, Nigeria, and Somalia. [redacted] 25X1

The rapid rise in the number of SAF arrangements—133 percent higher than yearend 1986—reflects the facility's recent introduction and the expanding need for medium-term assistance. Most of the structural adjustment arrangements begun last year, as in 1986, were approved for African countries, including the Central African Republic, Chad, Guinea, Guinea Bissau, Madagascar, Mozambique, Somalia, Tanzania, Uganda, and Zaire, as well as Bangladesh and Nepal. [redacted] 25X1

. . . But Net Disbursements Decrease

Despite the increase in the number of arrangements last year, net financial flows to the LDCs were a negative $3.6 billion as of October 1987—compared with a negative $2.2 billion in 1986. Moreover, net financial flows could be as low as negative $4.3-4 billion by yearend 1987. Net negative financial flows were mostly a result of members' repayments of large Fund borrowings that were incurred during the earlier years of the debt crisis as well as reduced new borrowings in 1987. [redacted] 25X1

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IMF Facilities and Arrangements

The IMF has several facilities to assist member countries who are experiencing short-term as well as medium-term balance-of-payments difficulties. LDC arrangements under these facilities allow members to borrow from the Fund's resources by using domestic currency to "purchase" either special drawing rights (SDRs)—the Fund's unit of account—or other member countries' currency up to a certain share of the borrower's quota—a member's subscription in the Fund. Repayments are made by using SDRs or other currencies specified by the Fund to "repurchase" or buy back the borrower's domestic currency. Borrowers must also pay a charge that reflects the Fund's borrowing costs plus a margin. Loan disbursements are usually made in installments and are generally contingent upon the borrower's ability to meet the economic criteria under a performance plan that it has developed with the Fund's assistance. A member risks a suspension in Fund disbursements if it fails to comply with performance criteria or repay its obligations to the Fund from a previous arrangement that has come due. Overdue obligations to the IMF can also prompt it to suspend the borrower's arrangement with the Fund. A variety of assistance facilities are available to member countries:

- *The* ***upper credit tranche*** *facility is intended to assist members in overcoming balance-of-payments difficulties, allowing them to draw up to 75 percent of their Fund quota. Borrowings are usually provided in the form of standby arrangements that include performance criteria and installment drawings. Standby arrangements usually last one to two years, and repayments are required within five years. The* ***first credit tranche*** *facility allows a member to borrow up to 25 percent of its quota. This facility does not require performance criteria or drawings in disbursements and is used when the member's balance-of-payments deficit is relatively small.*

- *The* ***extended fund facility*** *is designed to assist members over a three-year period in overcoming structural maladjustment, cost-price distortions, or poor export performance that result in balance-of-payments problems. Extended arrangements allow members to borrow up to 140 percent of their individual quota, although the borrower must have an annual program of policies to correct these problems as well as meet performance criteria to be eligible for disbursement installments. These arrangements require repayments within four and a half to 10 years.*

- *The* ***enlarged access facility*** *is used to provide additional longer term funding under standby arrangments and extended arrangements for members who face substantial payment imbalances that exceed resources available to them under the upper credit tranche and extended fund facilities. Repayments must be made within three and one half to seven years and conditionality also applies to disbursements from this facility.*

- *The* ***structural adjustment facility*** *(SAF) was introduced in 1986 to provide loans to low-income member countries who are experiencing prolonged balance-of-payments problems and have implemented medium-term macroeconomic and structural adjustment programs. In order to be eligible, these low-income countries cannot be internationally creditworthy and must have a per capita GNP of less than $750. Under their structural adjustment arrangements, member countries are allowed to borrow up to 63.5 percent of their quota over a three-year period with installment drawings contingent upon performance criteria. Repayments must be made within 10 years with a five-and-a-half-year grace period. Under the new enhanced structural adjustment facility (ESAF)—which was announced in late December—eligible member countries will be able to borrow up to 250 percent of their quota. Repayments must be repaid over 10 years with a five-year grace period.*

- *Other IMF lending resources include the* ***compensatory financing facility*** *(CFF) and the* ***buffer stock financing facility.*** *The CFF is designed to help members who are experiencing a temporary excess in the cost of cereal imports or temporary export shortfalls caused by external factors. The buffer stock financing facility is set up to help finance member countries' contributions to international commodity buffer stock schemes, subject to balance-of-payments needs. Borrowings from these facilities must be repaid within 39 months to five years.*

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LDCs: Status of IMF Arrangements, as of 31 October 1987

Million US $

	Type of Arrangement	Date of Expiration	Agreed Amount	Undrawn Balance
Total			**9,215.2**	**4,621.1**
Latin America			4,605.6	2,023.4
Argentina	Standby	30 Sep 88	1,470.4	1,093.2
Bolivia	SAF [a]	14 Dec 89	76.1	52.1
Chile	Extended	14 Aug 88	990.8	264.2
Costa Rica	Standby	31 Mar 89	66.1	66.1
Dominica	SAF	25 Nov 89	3.4	0.7
Haiti	SAF	16 Dec 89	37.0	25.3
Jamaica	Standby	31 May 88	112.3	59.4
Mexico	Standby	1 Apr 88	1,849.5	462.4
Sub-Saharan Africa			2,473.1	1,909.9
Burundi	Standby	31 Mar 88	27.7	27.7
	SAF	7 Aug 89	35.8	24.5
Central African Republic	Standby	31 May 88	10.6	9.2
	SAF	31 May 90	25.5	17.5
Chad	SAF	29 Oct 90	25.7	17.6
Congo	Standby	28 Apr 88	29.6	17.0
Cote d'Ivoire	Standby	22 Jun 88	132.1	100.4
Gabon	Standby	31 Dec 88	130.4	80.9
Gambia	SAF	16 Sep 89	14.3	9.8
Guinea	Standby	28 Aug 88	15.3	15.3
	SAF	28 Jul 90	48.6	33.3
Guinea Bissau	SAF	13 Oct 90	6.3	4.3
Madagascar	Standby	16 Feb 88	39.6	13.2
	SAF	30 Aug 90	55.7	38.2
Mozambique	SAF	7 Jun 90	51.2	35.1
Niger	Standby	4 Dec 87	13.4	5.4
	SAF	16 Nov 89	28.3	19.4
Nigeria	Standby	31 Jan 88	858.7	858.7
Senegal	Standby	25 Oct 88	28.1	22.7
	SAF	9 Nov 89	71.4	15.2
Sierra Leone	Standby	13 Nov 87	30.6	20.0
	SAF	13 Nov 89	48.6	33.3
Somalia	Standby	28 Feb 89	43.8	36.5
	SAF	28 Jun 90	37.0	25.4
Tanzania	Standby	27 Feb 88	84.8	24.7
	SAF	29 Oct 90	89.8	61.5
Togo	Standby	8 Apr 88	30.4	19.0
Uganda	SAF	14 Jun 90	83.6	57.2
Zaire	Standby	14 May 88	132.1	99.7
	SAF	14 May 90	244.1	167.2

LDCs: Status of IMF Arrangements, as of 31 October 1987 (continued)

Million US $

	Type of Arrangement	Date of Expiration	Agreed Amount	Undrawn Balance
Asia			1,323.8	325.3
Bangladesh	SAF	15 Feb 90	241.2	165.2
China	Standby	4 Nov 87	789.7	0
Nepal	SAF	13 Oct 90	31.3	21.4
Philippines	Standby	23 Apr 88	261.6	138.7
North Africa/Middle East			812.7	362.5
Egypt	Standby	30 Nov 88	330.3	177.0
Mauritania	Standby	3 May 88	13.2	7.9
	SAF	21 Sep 89	28.4	19.5
Morocco	Standby	31 Mar 88	303.9	105.7
Tunisia	Standby	3 May 88	136.9	52.4

[a] Structural Adjustment Facility.

[redacted] 25X1

Total borrowings in 1987, as in 1986, continued to be drawn mostly from the IMF's credit tranche facility, which includes standby arrangements. One-half of the members' borrowings from the Fund last year—$2 billion—were under the credit tranche facility, down from an 80-percent share in 1986. Drawings under the compensatory financing facility (CFF)—a facility for temporary export shortfalls—accounted for 38 percent of total disbursements. Borrowings under the extended fund facility and the SAF accounted for only a small share of total drawings. Regional access to funds was heavily in favor of Latin America last year, although Sub-Saharan Africa accounted for the majority of the number of LDC arrangements with the IMF. [redacted]

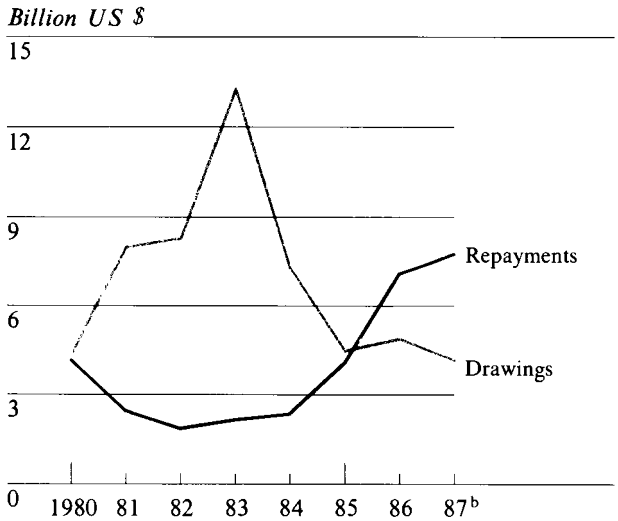
LDC repayments—also known as repurchases—to the Fund amounted to $7.7 billion last year, as of 31 October, of which nearly half were made to the credit tranche facility. Repayments to the CFF accounted for 31 percent of total LDC repayments. Latin America accounted for more than one-third of repurchases, while Asia was the second-largest repayer, totaling 24 percent of LDC repurchases. [redacted] 25X1

And Arrears and Noncompliance Remain A Problem

The problem of arrears—overdue obligations to the IMF—and noncompliance, which is a failure to meet performance criteria under IMF economic adjustment programs, continue to be a thorn in the IMF's relations with the LDCs. IMF programs have been suspended in six countries because of overdue obligations to the Fund—which totaled $1.5 billion as of 30 April 1987.[1] Overdue obligations were only $0.6 billion on 30 April 1986. These arrears are approximately equal to the Fund's reserves, although they are relatively small, compared with outstanding Fund credit. To strengthen the IMF's financial position, the Executive Board raised the target for the Fund's annual net income from 5 percent of reserves to 7.5 percent for 1986-88. [redacted] 25X1 25X1

[1] The six countries and suspension dates are Peru, August 1986; Guyana, May 1985; Liberia, January 1986; Sudan, February 1986; Viet Nam, January 1985; and Zambia, September 1987. [redacted] 25X1

IMF: Comparison of Total Drawings and Repayments, 1980-87[a]



[a] Excludes purchases in the reserve tranche and trust fund loan disbursements.
[b] As of 31 October.

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Failure to meet economic criteria under IMF-supported programs—risking a suspension in fund disbursements—is also a major problem. Somalia and Zaire, for example, are out of compliance with their IMF-supported programs, while Bolivia and Egypt are on the verge of failing to meet their economic criteria. Zaire exceeded its 30 September standby target on net credit to the government by $50 million and probably also missed its 31 December target. According to Embassy reporting the IMF recently requested Cairo to devalue its official exchange rate, increase interest rates, raise agricultural and energy prices, and reduce its fiscal budget deficit. Argentina and the Philippines recently received waivers from the Fund's Executive Board after Buenos Aires failed to meet its targets for reducing inflation and the fiscal deficit and Manila was unable to meet its net international reserve level target.

Prospects for 1988

We believe the LDCs will urge the IMF to accept reform programs with less stringent austerity requirements and will call on commercial banks to untie loan disbursements from Fund program compliance. LDC leaders are calling for economic growth at the expense of reform as austerity programs become increasingly unpopular domestically. Some LDCs probably will push commercial banks—as Brazil has done—to agree to delink their loan disbursements from IMF loan disbursements. We expect some LDCs, such as the Philippines and Argentina, will continue to experience difficulty in achieving program compliance this year—possibly risking a suspension of IMF as well as commercial bank loan disbursements. The issue of arrears is also likely to remain this year, posing a problem for the debtors by prompting a suspension of their IMF program as well as for the IMF by restricting the Fund's ability to lend. 25X1

Despite these problems in LDC-IMF relations, we believe the LDCs will continue, for the most part, to rely upon the IMF as a source of funds and a provider of technical assistance in designing and monitoring economic restructuring programs. Moreover, IMF involvement will continue to be important for debtors who are seeking funds from commercial banks because the banks usually require an IMF arrangement for new funding or multiyear rescheduling packages. Finally, Japan is expected to require LDCs to have an active IMF-supported program to benefit from Tokyo's capital recycling program, providing a carrot for some LDCs, especially in Latin America, to maintain or return to an arrangement with the Fund. 25X1

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Despite net negative disbursements and sometimes contentious LDC-IMF relations because of tough conditionality, the Fund will continue to play a central role this year in continuing international efforts to resolve the LDC debt situation. Moreover, the IMF will probably take a slightly more flexible and more growth-oriented approach to the debtors' situation, although it will probably continue to require the LDCs to achieve performance criteria to be eligible to receive disbursements from the Fund. The IMF, for example, recently created an $8.4 billion ESAF—proposed last year by the IMF's Managing Director, 25X1

Michel Camdessus—which will complement its existing $3 billion SAF. Use of the ESAF will probably be boosted by the IMF's decision to allow LDCs with existing SAF arrangements, which allow them to borrow only up to 63.5 percent of quota, to switch to ESAF arrangements that have a maximum of 250 percent of quota. [redacted] 25X1

The IMF is also considering a US proposal to change performance criteria and disbursements from quarterly to semiannual for extended arrangements or standby arrangements that are longer than 18 months as well as include structural reform measures in programs through performance criteria. The IMF is considering another US proposal to create a new facility—external contingency facility (ECF)—to replace the CFF. Like the CFF, the ECF would provide medium-term assistance to members facing export earning shortfalls and higher-than-expected increases in import prices. The ECF, however, would also provide assistance to countries in the event of unanticipated higher interest rates. [redacted] 25X1

[redacted] 25X1

USSR–Eastern Europe: Inching Toward Currency Convertibility in Intra-CEMA Trade

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At the October meeting of CEMA [1] premiers, the USSR acknowledged for the first time that an overhaul of Bloc financial relations is needed to spur closer economic integration and better quality exports from Eastern Europe. The premiers agreed on the first tentative steps toward currency convertibility in intra-CEMA trade, but these measures will have little immediate impact on trade. Widespread convertibility is, at best, many years away and depends upon sweeping reforms in the domestic economies. Nonetheless, prospects for movement toward convertibility are better now than ever, and, if Moscow and its supporters can push through their ambitious plans, CEMA trade and economic performance should improve substantially in the 1990s.

Inconvertibility: Achilles' Heel of CEMA Trade

Currency inconvertibility is rooted in the basic mechanism of the centrally planned economies: planners rather than market forces determine what goods are produced and for what purpose. Money has no power over economic activity because, in theory, no amount of rubles can attract resources away from a use specified in the plan. Although reforms have weakened the planners' authority in many CEMA countries and given more scope to profits in economic decision making, currencies remain limited in their influence over resource allocation.

The CEMA countries have debated for more than 20 years the need for a convertible currency and the elimination of bilateral settlement of intra-Bloc trade. Spurred in part by complaints from East Europeans, the 1971 "complex program" for CEMA integration called for convertibility. No steps were taken to achieve this goal because of a slowdown in the CEMA economies, the uneven levels of development of the individual countries, and the inadequate quality of goods. Moreover, the proposals stood no chance as long as the USSR showed no interest in convertibility.

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The failure of CEMA's past efforts to introduce convertibility deterred the expansion of intra-Bloc trade and the resulting gains in efficiency and quality. Countries have little incentive to boost exports to CEMA partners because they cannot use transferable rubles earned through trade surpluses to increase imports from the bilateral partner or a third partner. The surpluses cannot be converted into goods because scarcities in these economies limit the availability and quality of goods for trade. In addition, exchange rates are set artificially, and differences in prices between economies play little role in attracting resources to their most efficient uses.

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CEMA Premiers Approve Limited Convertibility

The October CEMA Council session—the annual meeting of the premiers of the member countries—devoted considerable attention to convertibility as one of the major reforms needed to improve trade. After discussing several sweeping proposals for convertibility, the premiers finally agreed that national currencies should be "mutually exchangeable" between enterprises with direct ties—those that have approval to bypass their own ministerial hierarchy to deal directly with counterparts in another country. In principle, for example, a Soviet enterprise could pay rubles to a Czechoslovak firm with which it has direct ties in order to buy machinery, parts, components, licenses, or services.

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Yet how much scope a CEMA enterprise, such as the Czechoslovak firm, would have in spending the currency from its exports is unclear. If a firm could

[1] Members of the Council for Mutual Economic Assistance (CEMA) include Bulgaria, Cuba, Czechoslovakia, East Germany, Hungary, Mongolia, Poland, Romania, USSR, and Vietnam.

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Disadvantages of CEMA's Trade System

Compared with market trade systems, CEMA's clearing trade arrangement is inflexible and offers weak or perverse incentives, resulting in inefficiency and lack of quality:
- *Annual trade protocols are negotiated the year before transactions occur, and five-year trade plans limit medium-term options.*
- *The need to balance trade bilaterally means that each purchase must be matched by a sale to the same partner.*
- *The heavy involvement of planners and foreign trade and industrial ministries leaves enterprises far removed from customers and suppliers.*
- *Holders of transferable rubles earned through a trade surplus have limited opportunities to spend them.*
- *Trade is set by plan targets rather than spurred by the profit motive.*
- *Inconvertibility encourages imports and deficits instead of exports and surpluses.*
- *Quantity is generally more important than quality.*
- *Prices do not give effective signals for directing economic activity and allocating resources.*

[redacted]

exchange the currency for another CEMA currency to purchase goods from another firm with which it has direct links, the new arrangement would be a limited, but still important step toward a more efficient multilateral payments system. Otherwise, the new convertibility has little meaning. Settlement would remain essentially a barter between the two partners, with only a limited selection of goods that could be purchased by the rubles earned from the sale to the USSR. [redacted]

Citing the CEMA decision, some East European countries have already announced some steps toward implementing limited convertibility. In late October, Hungary and Poland agreed that profits from joint ventures will be distributed in the currency of the country in which the operations are located. At the same time, Czechoslovakia announced a streamlined exchange rate system to go into effect at the beginning of 1989. [redacted] 25X1

Odd Members Out. The CEMA premiers deferred proposals for wider convertibility for further study amid apparently sharp disagreements. In a press conference following the CEMA session, CEMA Secretary Sychev indicated that the decision to pursue limited convertibility was not supported by Romania and East Germany.[2] Both countries, which adamantly oppose Gorbachev's agenda of decentralizing reforms and joint ventures between CEMA enterprises, reportedly objected that convertibility would undermine their governments' control over economic policy. Romanian Premier Dascalescu, citing the requirement for unanimity on major CEMA decisions, even threatened implicitly Bucharest's withdrawal from CEMA if the principal of unaminity were abandoned. The other East Europeans sharply criticized Romania's and East Germany's refusals to go along [redacted] 25X1

Outlook

The premiers' decision on convertibility will have a negligible impact on CEMA economic relations for the next few years. Because the agreement covers a very small volume of transactions and leaves open many questions about how it will work, nearly all of the supporters of convertibility emphasized that implementation must be gradual. A Soviet economist told the press in early November that, even under favorable conditions, five or six years will be required to achieve convertibility. [redacted] 25X1

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This small step toward convertibility, nonetheless, testifies to the determination of the USSR and several of the East European CEMA countries to consider major changes in the way they do business. The prospects for genuine convertibility have improved now that the USSR is taking the lead in pushing for reform of CEMA's monetary system, and support 25X1

[2] Vietnam also did not approve convertibility. [redacted] 25X1

among the East Europeans has broadened from longtime advocates, Poland and Hungary, to recent converts, Czechoslovakia and Bulgaria.

The chances of eventual convertibility are also enhanced by the improved climate for economic reform. Partly inspired by Gorbachev's agenda in the USSR and partly for their own reasons, most of the East European countries have announced new economic reform packages this year. Indeed, progress on convertibility will depend heavily on the implementation of economic reforms in the USSR and Eastern Europe. More rational internal pricing and more effective domestic financial mechanisms are essential to establishing currency convertibility among the CEMA economies.

While the CEMA premiers' decision to study further financial reforms delays major changes, the continued drafting of proposals will keep convertibility a live issue. The experiment to exchange national currencies between enterprises with direct ties will be important in determining what further steps toward convertibility can be taken. Answers to several key questions are likely to emerge as enterprises feel their way toward limited convertibility.

Wide-Ranging Implications

Progress toward convertibility touches—at least tangentially—on a large number of issues in Soviet–East European economic relations. In most cases, the linkages run in both directions: greater convertibility and developments in other key areas are mutually reinforcing and inseparable.

CEMA Integration. Achieving the longstanding vision of a single CEMA market will require full convertibility of the national currencies. Linking the economies through a network of meaningful exhange rates and effective currencies would sharply increase the economic interdependency of the CEMA countries and make their economies more open to each other.

Convertibility Between Western and CEMA Currencies. Because intra-CEMA convertibility would rationalize foreign and domestic prices and foster quality and export orientation, some of the major hurdles to convertibility with Western currencies would be cleared. It would still require a substantial leap for the 25X1 CEMA economies to be strong enough to face world competition. In any case, Gorachev and his East European counterparts do not plan to carry the reforms this far, and this would undermine Bloc economic unity. 25X1

Economic Reform. Domestic reforms may be driven to some extent by changes in CEMA. Moscow has not yet pushed the East Europeans hard to undertake specific reforms, but progress on convertibility may require the East Europeans to reform their foreign trade and revise their exhange rate systems.[3] Indeed, pressure for convertibility could be a lever against the 25X1 more recalcitrant members. Alternatively, continued adherence to central planning by Bucharest and East Berlin could frustrate efforts toward convertibility and test Moscow's hands-off policy toward reform in Eastern Europe. 25X1

Foreign Trade. The uncertainty about convertibility will complicate negotiations set to begin next year on 1991-95 trade plans. While the new procedures will have little impact on the remainder of the 1986-90 25X1 trade plans, the coming five-year plan may well see a significant impact from changes in monetary relations. Heightened importance of money in driving CEMA economic relations would make trade more flexible and thus reduce the authority of—if not the need for—detailed trade plans. 25X1

Quality. The achievement of widespread convertibility would promote Gorbachev's goal of improving the quality of goods traded in CEMA. Trade surpluses 25X1 and transferable ruble balances are now undesirable because only shoddy surplus goods are available for purchase. If countries holding currency surpluses were able to convert them into goods, competition should spur trade partners to offer more desirable goods.

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[3] Moscow is sending mixed signals: the Soviet delegation at the CEMA session was clearly frustrated by the resistance of East Germany and Romania, but Gorbachev's published remarks to the 25X1 premiers after the meeting appear to leave decisions about reform up to the individual countries. 25X1

Pricing. Both within the CEMA economies and in intra-CEMA trade, price-setting mechanisms will have to be substantially revised to become more flexible. CEMA foreign trade prices, which are presently based on the average of world market prices over the previous five years, will have to be closer to current Western prices, or the CEMA countries will have to develop their own market price system. This, in turn, will require a closer relationship between domestic and external prices and some convergence of prices in all of the CEMA economies.

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Briefs

Energy

Norway Concerned About Fast Pace of Oil and Gas Development

Norway is facing difficult policy decisions about the development of major projects that are crucial to the level of North Sea oil and gas output in the mid-1990s and beyond. A rash of oil and gas company applications is expected soon for large new projects. If it approves all the projects, Oslo believes a huge, inflationary bulge in offshore investment would occur, followed by a gap in investment in the mid-1990s, with depressing effects on the country's offshore industry in the future. Oil companies argue that enforced delays would place intolerable strain on field economics in view of the money already spent, thus souring interest in further exploration and development of Norwegian fields. Ironically, it was Oslo's easing of tax terms a year ago because of plunging oil prices that has led to the surge of interest in development projects. [redacted] 25X1

International Finance

Panama's Financing Problems

Panama's prospects for securing external funding to help finance a projected budget gap of more than $300 million this year are poor. The US Embassy reports that government officials are counting on at least $260 million in new loans from commercial banks, and from the IMF, the World Bank, and the Inter-American Development Bank; they plan to siphon profits from government-owned companies to cover the remaining shortfall. [redacted] Panama 25X1
also is depending on foreign commercial banks to honor a suspension of debt payments until March, even though the regime has not obtained a promised IMF letter of intent. Foreign private banks probably will maintain the debt moratorium, realizing that Panama does not have the money to pay servicing obligations and that declaring Panama in default might cause renewed capital flight. The banks will be reluctant to offer new money without an IMF accord, however, and the regime does not want to risk unrest by making other far-reaching reforms. Meanwhile, growing financial difficulties might increase Panama's interest in funding from the Soviet Bloc and Libya. [redacted] 25X1

International Trade

Rosy Rhetoric, Practical Problems for West German-Soviet Trade

Recent positive rhetoric from high-level West German and Soviet officials about their bilateral trading relationship disguises many practical obstacles that are hindering expanded trade. Foreign Minister Genscher and Christian Social Union leader Strauss are publicly urging the West to take Gorbachev's reforms seriously, and to take steps to assist the Soviet leader's domestic restructuring program. Genscher and Strauss both stress the special importance of Bonn's trade link to Moscow, and Genscher recently argued for relaxing COCOM restrictions, which the Soviets claim have cost the West German firm Siemens substantial business. Despite such encouraging statements, a number of factors are hindering the economic relationship. West German exports have actually dropped almost continously in real terms for the past four years when measured on a quarterly basis—largely reflecting a drop in Soviet oil revenues—with investment goods and machine tools down sharply in the past year. Joint ventures are being hampered by the lack of a bilateral investment guarantee. Moscow, nearly a year after indicating its willingness to negotiate such an agreement, is now reportedly ready to do so, although West German officials are skeptical the Soviets will sign the basic West German guarantee, which ensures an unrestricted transfer of profits in hard currency. Quotas and tariffs on goods such as textiles also hinder trade, although Bonn has pledged to seek a more accommodating position on this within the EC. [redacted] 25X1

Thai-Soviet-Japanese Trade Venture

The Asian-Pacific Company (ASPAC), a first-ever marketing arrangement between Thai, Soviet, and Japanese firms, is scheduled to begin operation in early January. ASPAC's partners recently met in Moscow to discuss trade proposals worth more than $1 billion. The largest deal probably will be a $660 million oil swap that would channel Soviet-origin or Soviet-traded petroleum through ASPAC, possibly to Vietnam, Laos, Cambodia, or China. Although the venture probably will boost Thai-Soviet two-way trade significantly from the $94 million recorded in 1986, a disagreement between the Japanese and Soviet partners over marketing rights for other Soviet products could slow the pace of sales elsewhere in the region. [redacted] 25X1

Global and Regional Developments

Italy Signs Economic Pact With Argentina

Italy and Argentina signed a five-year $4.5 billion aid and investment accord last month, but disbursement problems and investor caution will probably leave the program short of its goal. Rome has committed $1.5 billion in soft loans over the 1988-92 period for public works and smaller "productive" nonpublic works projects, namely industrial projects. The projects are expected to involve about $1.5 billion in Italian private investment and an equal amount of repatriated Argentine capital. Rome already has allocated about $240 million in soft loans to a gas processing plant project at Neuquen and a telephone digitalization project in Buenos Aires. Argentina must exempt Italian investments from capital and profit repatriation restrictions to attract wary investors and establish a financial administrative entity before the program can get off the ground. More important, Argentina must streamline administrative procedures to implement the small, nonpublic works projects that are expected to account for a large portion of the program. According to Embassy reporting, a $270 million Italian soft loan program initiated in 1985 to encourage investment by small and medium-sized Italian firms has been little used because of Argentine bureaucratic inefficiencies.
[redacted] 25X1

Algerian-French Economic Relations Deteriorate

The failure of year-long talks to yield a liquefied natural gas contract is souring Algerian-French relations. Algeria is holding out for a 20-year, fixed-price, fixed-quantity contract while the French want market price fluctuations taken into account. Algerian frustration over the deadlock has led Algiers to abrogate existing maritime and aviation accords with France. Moreover, according to the US Embassy in Algiers, the government is threatening to freeze $100 million in transfers due Air France and is drawing up proposals to cut back French imports drastically. Although the Algerians may delay payment to French firms for services rendered, they are unlikely to pursue policies—such as declaring a moratorium on debt owed the French—that would jeopardize their international credit rating. The decline in Algerian-French relations could create opportunities for more US commercial activity with Algeria. [redacted] 25X1

Turkey Disappoints Iran's Hopes for Economic Cooperation

Iran failed to achieve its major objectives at the latest meeting of the Economic Cooperation Organization (ECO)—a group founded four years ago and consisting of Iran, Turkey, and Pakistan—[redacted] At the November meeting, Tehran sought the immediate elimination of certain tariffs, broad movement toward a free trade area, and unlimited truck transit rights within ECO. Ankara apparently resisted these proposals because they either decrease Turkish revenues or detract from Ankara's drive to join the EC; Tehran has frequently touted ECO as the forerunner of an alternative, Islamic, common market. In addition, the same issues are to be discussed at the Turkish-Iranian joint economic meeting scheduled for early 1988, and Turkish officials may not have been prepared to negotiate these points during the ECO meeting. Pakistan was reportedly more favorably disposed to the Iranian proposals, but it may have coordinated its positions in ECO with Turkey to prevent Iran from dominating the organization. ECO will probably continue to face difficulties in finding agreement among its parties, in part because Ankara accords it a much lower importance than Tehran. ([redacted] 25X1

National Developments

Developed Countries

Renewed Strains Over West German Economic Policy

Public splits within the Kohl government over economic policy have begun to reemerge. Economics Minister Bangemann recently suggested that additional steps to stimulate the economy might be needed, but Chancellor Kohl ruled them out. The public differences were quickly papered over by a senior Economics Ministry official, who stressed that both Bangemann and Kohl agree nothing needed to be done now, and that Bangemann had simply reiterated his view on policy action if the economy stagnates. Bangemann, however, was almost certainly reflecting the view of his Free Democratic Party that Bonn needs to do more to stimulate growth. Most party members rejected the government's recent investment program as grossly insufficient. Moreover, former Economics Minister Lambsdorff continues to urge enactment of the Stability and Growth Law, which would involve substantial tax cuts. Chancellery officials, although supportive of the goal of additional stimulus, were critical of Bangemann's remarks; they claimed airing a dispute with the Chancellor could create uncertainty about the government's policies and undercut investment. Kohl and Christian Democratic Ministers remain more concerned about Bonn's growing budget deficit, which almost certainly will be one-third higher than currently projected. 25X1

25X6

25X6

Canada Increases Agricultural Subsidies

Ninety percent of Canada's farmers will benefit from farm subsidy programs in 1988, with most help going to western grain producers. Ottawa plans to give farmers $825 million in direct cash payments under a special program established last year to help protect farmers from the international grain subsidies war. In addition to the direct payments, Ottawa will write off more than $750 million in farm-related debts, including half of the $1.1 billion accumulated debt of a government-sponsored crop insurance program. Ottawa also has offered $225 million over the next three years to the Farm Credit Corporation—the lender of last resort for farmers—to cover future loans. In total, Ottawa and the provincial governments probably will give farmers nearly $3 billion in direct and indirect aid in 1988. Although revenue from crop sales fell by about 6 percent in 1987, government grants raised net farm income to a record high, and we expect 60 percent of net farm income in 1988 will again come from Ottawa and the provincial governments. The planned 1988 disbursements exceed those called for in last spring's budget estimates, and since offsetting cutbacks elsewhere are unlikely so soon before an election, Ottawa is likely to miss its budget deficit target this year. 25X1

Israeli Cabinet Approves 1988 Budget

According to press reports, Finance Minister Nissim gained Cabinet approval on Sunday for the 1988/89 government budget—which begins on 1 April—following intense behind-the-scenes negotiating. The budget is for 48.6 billion shekels—about $30 billion at the current exchange rate—and provides for about $470 million in spending reductions. Subsidy reductions of about $180 million and across-the-board cuts by government ministries of about $200 million comprise the bulk of the proposed cuts. The Cabinet-approved budget now goes to the Knesset for final approval. While it is not likely that major budget changes will take place in the Knesset, further chipping away—especially from the proposed across-the-board ministerial cuts—is probable before the budget ultimately is passed. 25X1

Less Developed Countries

Thai Economy Shows Dynamic Performance in 1987

A second year of high export growth—coupled with strong foreign investment inflows and a recovery in domestic demand—pushed Thailand's real GDP growth to more than 6 percent last year, while inflation was held to 3 percent. On the basis of preliminary figures from the Central Bank, we estimate that exports increased by 25 percent compared with 1986 levels, to $11.3 billion. Sales of processed raw materials and manufactured products almost doubled, and exports to the United States were up more than 20 percent, to almost $2 billion. A 37-percent surge in imports pushed the trade deficit to $1.5 billion, however, and the current account moved from a small surplus in 1986 to a deficit of $580 million, or slightly more than 1 percent of GDP. With capital inflows of more than $900 million in 1987—much of it Japanese investment—and the likelihood that exports and investment will remain strong, we estimate that the real GDP will grow at about 6 percent again in 1988. 25X1

India's Private-Sector Profits Decline

Declining private-sector profits may have an adverse impact on New Delhi's economic liberalization program. According to US Embassy reporting, the after-tax profitability for the private sector is expected to decline from 14 percent in the fiscal year that ended March 1987 to 7 percent in this fiscal year. New Delhi had hoped that liberalization measures, which include reducing restrictions on imports and industrial production and reforming the tax system, would help modernize the industrial sector and boost output significantly. The government has looked to a more efficient and profitable private sector as an increasingly important source of funds to finance industrial expansion. Some industrialists complain that liberalization, especially higher imports, are hurting the country's private industrial sector. We believe, however, that the severe drought over the last year—which has reduced income and demand for many industrial and consumer items—as well as the inability of Indian firms to quickly adapt imported technology, continue to be the major factors hampering Indian competitiveness and output. Moreover, longstanding structural deficiencies such as high cost inputs and inadequate power supplies are also major constraints. Opponents of liberalization nevertheless will continue to blame the program for the country's slower industrial performance and press New Delhi to back away from its commitment to implement further liberalization measures. 25X1

Afghan Currency Depreciating

Afghanistan's currency has declined sharply against the US dollar and other foreign currencies on the Kabul free market during the last month, after remaining fairly stable since early August. The afghani currently stands at an unprecedentedly weak 189 afghanis to the dollar, a drop of 8.6 percent since late November. According to the US Embassy, the decline was triggered, in part, by the increased demand for hard currency in late November when the regime offered a large quantity of sugar for sale to local businessmen and required payment in hard currency. The depreciation probably is also the result of the uncertain political situation and a decline in Afghanistan's hard currency exports—in particular raisins and karakul pelts—this fall. The afghani's decline will make Western imports—such as machinery and medicines—more expensive and may contribute to rising prices for some food items in the bazaar. [redacted] 25X1

Nigerian Finance Minister Hangs On

Finance Minister Chu S.P. Okongwu not only survived a cabinet reshuffle in December—despite rumors of his impending replacement—but gained the Economic Development portfolio. His expanded authority should simplify the budgetary process, according to US Embassy officials, and eliminate existing tension between the two ministries. These same officials, however, report that Okongwu is not an effective spokesman for the regime's austerity measures. His abrasiveness, unpredictability, and lack of knowledge of economic details have earned him poor marks from his own ministry, the Armed Forces Ruling Council, and the domestic and international business communities, according to Western diplomats. Okongwu's frequent charges that the international community has not provided enough new financing for Nigeria and his propensity to nitpick at nearly completed agreements have caused delays in debt rescheduling. Okongwu is reportedly close to President Babangida, a relationship that probably accounts for his continuation in high positions. [redacted] 25X1

Haiti's Efforts To Cope With Foreign Aid Cuts

Haiti is trying to ease the impact of recent aid cuts but probably will face a financial crisis shortly after the election period ends early next month. To cope with the suspension of $69 million in US and multilateral balance-of-payments support, Port-au-Prince has raised gasoline taxes, delayed paying civil servants, and announced a 20-percent cut in the salaries of military officers, according to the US Embassy. The ruling council almost certainly wants to avoid imposing austerity measures before the scheduled inauguration of a civilian president on 7 February. The military salary cuts merely rescind a portion of the 90-percent increase in base pay granted to all military personnel in October. To retain the military's loyalty, the government probably will shift the burden of most budget cuts to the civilian sector. Such a move, however, risks a new round of popular unrest as the full impact of the measures begins to take hold by March [redacted] 25X1

Communist

China's Trade Balance Improves

China reduced its trade deficit to $3.5 billion in 1987 from $12 billion in 1986. Chinese customs statistics indicate that a 23-percent surge in exports accounted for much of the improvement, but the imposition in early 1987 of stricter controls on the use of foreign exchange resulted in a 3-percent decline in imports. China's merchandise trade balance, net of insurance and shipping charges, was probably in surplus for the last two quarters, after 11 consecutive quarters in the red. In addition, income from services was probably up significantly—earnings from tourism were up 30 percent through October, for example—suggesting China will post its first current account surplus since 1984. Accordingly, China's foreign exchange holdings almost certainly have grown since Beijing reported its September reserves had reached $14 billion, a $4 billion jump from January's level. China's external accounts will probably continue to improve despite growing protectionism in many developed-country markets. For example, in the last half of 1987, the value of China's textile exports—the nation's largest foreign exchange earner—increased 25 percent despite the filling of many Western quotas on Chinese goods. As a result, Beijing will probably ease import restrictions in 1988. Beijing's success in promoting exports is largely responsible for its widening trade surplus with the United States. US statistics project a $3.8 billion gap for 1987, double the level of 1986. [redacted] 25X1

Hanoi Facing Critical Shortage of Foreign Exchange

[redacted] a critical shortage of foreign exchange is forcing 25X1 Vietnam to cut export prices. A recent Vietnamese delegation to Bangkok was instructed to negotiate a coal sale at any price in order to obtain currency to repay overdue debts, [redacted] Hanoi is also trying to support 25X1 construction projects without spending hard currency by bartering scrap metal for fabricated steel. Vietnam's foreign exchange woes—the IMF estimates that reserves are less than $10 million, or about three days worth of imports—will probably continue over the next year. Prospects for increasing foreign exchange revenues are poor because of Hanoi's almost total dependence on exports of agricultural products and handicrafts. In addition, Vietnam's occupation of Cambodia and its poor credit rating have isolated Hanoi from Western financial assistance. [redacted] 25X1

Vietnam's Economic Reforms

Hanoi has introduced economic reforms designed to force state-run enterprises to operate more profitably and to lure badly needed foreign investment; results are likely to be mixed. The new measures allow state-run firms more autonomy in hiring, investing, pricing, and disposing of unwanted assets. In return, enterprises will be held accountable for their profits and losses; those perennially in the red will lose their subsidies and be forced into bankruptcy. Hanoi has also given final approval to a long-awaited foreign investment code allowing as much as 99-percent foreign equity in joint ventures, repatriation of profits, and full investor control over work forces; the only areas closed to foreign investment are defense and public utilities. The new measures lack clear guidelines on how far enterprises may go in exercising their decisionmaking authority; the ambiguity risks more confusion than benefits. Enterprises are likely to test the limits of their authority, for example, by sharply increasing investment and imports, thereby aggravating inflation and foreign exchange problems. Despite the new foreign investment code, most Western firms are not likely to risk investing in Vietnam because of the country's weak banking system, poor infrastructure, and massive, inefficient bureaucracy. [redacted] 25X1

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